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ISBC Business Discussion Group

Discussions on International Payment Terms

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The original 2 related questions.

From: "Brad L. Oxendine"
To: bus@isbc.com
Subject: Question on open accounts to foreign customers

Dear Nick,

Many of my customers are located in different countries and some of them are fortune 1000 companies. I have been informed by most of my customers from Europe that 90 day net is the normal payment time. Does anyone know if this is a true statement? Also, I have not had any luck in getting any of my foreign

customers to open a letter of credit. Besides not accepting their orders unless they open a letter of credit, does anyone know of another way to get them to do so? Is there another way to make fairly sure that we will be paid, without having a letter of credit from them. Also, how does one go about collecting overdue payments from a foreign customer?

Thank You,

Brad
American Circuit Technology, Inc.

To: nick@isbc.com
From: Great Wall Products
Subject: Wire Transfers

We are starting to export to Central and South America. Are there any problems associated with accepting wire transfers for payment? And is this the best route to go for customer payments?

Bruce Kahn
Great Wall Products

The Responses.

From: Joan Faber
To: Nick Baker
Subject: Getting Paid -- Joan Faber

To Bruce:
>From lowest risk to highest risk it goes like this:(short form)
1. Cash in Advance: before shipping..usually wire transfer.
2. Letter of Credit: issued by buyer's bank, substituting its credit worthiness for that of its client. This is the one most often used.
3. Documentary Collection: Under instructions from the seller, a bank presents a draft and documents associated with a sales transaction to the buyer's bank for immediate ('sight') or deferred ('acceptance') payment.
4. Open Account: Seller ships his merchandise and forwards the necessary shipping and commercial documents directly to the buyer.

Joan Faber
Faber Associates International Marketing
Tel:(201)376-6104
Fax:(201)376-3019
faber@mail.idt.net

To: bus@isbc.com

From: slewis@ptd.net (Sally Lewis)
Subject: Re:Wire transfer -- Sally Lewis

>From what I understand international wire transfers can be a bit tricky. You may want to look into services like Western Union. They used to have a service called "Quick Collect" where they charge a flat fee and take care of the transfer and currency exchange. It used to be that in many cases this service was quicker and more economical than dealing with banks and their service charges.

Sally Lewis - Marketing Manager
http://www.1travel.com
800-901-0600
Airfare Discounts of up to 70% off departing from 20 countries worldwide

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From: MFKAPLAN@aol.com
To: bus@isbc.com
Subject: Accounts for Foreign Customers

In response to Brad's question about payment from European clients, yes 90 days is the norm in Europe. In Italy, it can run to 180 days. This is true with Fortune 1000 firms as well as small firms. The advantage of dealing with Fortune 1000 firms that do business in the U.S. is that they don't want to ruin their credit rating here. So the threat of reporting them to D&B or some other credit reporting bureau often loosens the purse strings. And if they have offices or agents here, you can use the U.S.legal system. My experience with large corporations is that they pay, but it takes a long time. I have little experience with smaller companies so can't offer any advice.

Marcia Kaplan

From: "Arnold Elser"
To: "Nick Baker"
Subject: RE: Question on open accounts to foreign customers

Greetings,

I am originally from Switzerland and can only confirm that in Switzerland it is very common to be billed for any invoices without any credit references or any kind of deposit. All residents and businesses have to be registered with the government. It is a Landlords duty to register tenants and businesses with the local government.

To get paid you could simple supply them with your bank account number and they should be able to wire the money right into your account. As far as non-payment I believe that the consulate of that country may be able to help you. The consulate may also be able to provide you with additional background information about a certain business.

Arnold Elser
Sweet Technology - Los Angeles
http://www.sweettechnology.com

pastrywiz@msn.com

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From: "Jack Wilner"
To: nick@isbc.com
Subject: Re: Wire Transfers

Re: Bruce Kahn's message -
"We are starting to export to Central and South America. Are there any problems associated with accepting wire transfers for payment? And is this the best route to go for customer payments?"

In my opinion this is the best route for customer payment. It has worked well for me. Here is what you need to be concerned about. When furnishing your wire transfer numbers and bank account numbers, be sure to only fax this information. I include it on my faxed invoice. Above all do not pass this information via e-mail. Be sure to include the wire transfer charges of about $30 at each bank as part of your handling charges. Sometimes the money is wired to a NY bank and then to your bank. This happened to me and there were wire transfer charges at each bank or a total of about $60. By the way I only accept payment before shipment.

Jack Wilner, Wilner & Associates, Inc. Ft. Lauderdale, FL, 33326, USA
Phone: 954-389-9745 Fax: 954-349-2466 Email: JDW52A@msn.com

From: Andres Vazquez
To: Nick Baker
Subject: Re: Brad Oxendine's Question on open accounts to foreign customers

Some members of ISBC are looking for help in dealing with foreign accounts especially in how to transfer funds when orders are received. My best advice to them is to look around for an experience export company who could advise them because each situation is different and even a L/C do not guarantee that you will receive your payment.

Second source of information is your banker but here again you have to be careful, I have seen bankers who do not have the slightest idea in how to deal with international customer and the wrong advise may cost you loosing a client.

Again Letters of Credit have to be read very carefully and remember they are no more than a promise to pay if certain conditions are met, these conditions have to be laid down by the supplier and the client has to agree. First thing I do believe it or not is to check the Bank that open the L/C, even a US Bank (we have many that go bankrupt), second thru your banker of D&B check your client references, third get yourself a good experienced international freight forwarder, they earn they money in the advise they can give to keep you out of hot water.

The preparations of the shipping documents is critical, if you do it make sure you know what you are doing.

Remember that after the goods leave the harbor they are under the control of foreign authority and in some countries as soon as the merchandise arrive it is nationalized that means that is against the law to re-export them consequently after some time and heavy fines, etc., it is auctioned to any bidder, one of them could be your own client.

There are many ways to eliminate the L/C, the best one is to ask for cash in advance or a transfer of funds to your account in a good international bank. You can send your cargo to be paid "at sight", that means that when the shipping documents are presented the corresponsal bank in the country where your client resides he should pay to the bank to be able to obtain the "original papers" and pick up the goods at the shipping line. This method has no guarantee of any kind that your client will pay you. He may not if he wishes then your cargo will be sitting in a foreign custom warehouse .

I hope this short lines can help some of your members, but please be extremely carefully when dealing with international accounts. Andres Vazquez

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To: nick@isbc.com
Subject: Re: Getting paid from overseas
From: mfgar@juno.com (Gary M Haslam)

Brad,

There are various options already available to be sure you get your money from international sales but you must be willing to insist that your customers use them according to your terms. My experience shows me that any company that balks at paying, using the standard conventions, is probably not worth doing business with. Be willing to move on - quickly.

Having said that, please understand that most successful international trade is based upon established relationships - trust - but, in the beginning, no one trusts anyone else. The initial vehicle for removing the distrust factor and guaranteeing the buyer gets his goods and the seller gets his money is the LC - letter of credit. The LC puts the financial transaction process in the hands of a third party, the bank. There are all kinds of letters of credit - see your bank for details.

The letter of credit is the wampam of international trade. In my opinion, any company unwilling to use or unknowledgeable in the use of LCs is probably going to cause you more trouble than the business is worth.

LCs allow buyers and sellers get to know each other and establish that all important relationship. Since there are cash flow consequences to using LCs, it is generally preferred to transact business on a cash basis as quickly as possible - convert to T/T (wire transfer) terms as soon as you can. T/T is sorely underated, in my opinion - is is less costly to wire money to a bank than it is to write a check and express mail it. Using the T/T vehicle, you can establish cash advance, COD or 30-60-90 day terms. In my experience, sellers are unlikey to provide more than 30 day terms and buyers will always want 90 terms.

Suggestions: Get your money as soon as possible; don't do the work until you have the cash or an LC in the bank; and mind the details! - LCs will kill you with the uncrossed t's and undotted i's.

Hope this helps.

Best regards,
Gary Haslam
Manufacturers Advanced Resources
mfgar@juno.com

To: Nick Baker
From: Alex santini
Subject: Re: Payment terms

Dear Nick,

I refer to the mail of Brad Oxendine regarding European payment terms. I am in the export businness sinxe 25 years and I guess I can give some advice.

1. European Payment terms. It is not true that normal payment terms are 90 days, not, at least in every country.

I am Italian and for Italy I can say YES, terms are long, because of trade habits. But to dealers it was not longer than 30/60 days. With present market situation (highly recessive) suppliers tend to prolong the terms and dealers ask for it. I would say that 90 days is a bit too long but happens. If we go to supermarket and department stores, terms are reaching 6-7 months. In Italy we ask for checks to be cashed at a later date: this is possible here because checks cannot be bounced and a bouncer of checks is punishable by penal law and in any event he cannot sign checks for two years. So a check is a good instrument. (do not forget that our average interest rate is between 12 and 16%/year).

Take as assumed that all "latin Countries" in Europe (Spain, Portugal, Greece etc.) work the same way.

2. Northern European countries. The style and habit was to pay net 30 days, cash 2% discount. This is drastically changing because the economies are recessive and long payment terms are usual in Germany as well Switzerland. The problem with these countries is the laws are not so drastic as in Italy regarding bounced checks, so you cannot trust a check.

One of the problems I face when dealing with L/C (letter of credit) is the cost of it in terms of opening and in term of cashing. One of the reasons we do not like to open L/Cs is the cost ranging around 1,2% of total value and same cost for cashing it. Any time we have to amend it is an extra cost and any amendement for the supplier is (at least in Italy) ca. 20 US$. On top an L/C assures only that something has been delivered but nothing assures me of the quality of what is delivered and once the L/C is paid many times is difficult to discuss. This may not apply to USA, there is always a BBB in the States, but I have had a personal bad experience with Taiwan and I got my money back only because the Government of the Island is strong against bad business practices.

On top of the costs involved with an L/C the bank, usually, when the L/C is opened takes away the amount of L/C for the current account, draining the cashflow of the company.

I am working right now with well known and established customers, I extend to them 30 and even 60 days credit on open account, they pay more or less regularly and I am happy. But my case is quite rare and most of all I work with USA, Japan, Korea, Hong Kong, Australia. People do trust my company as well and they, if they can, pay me also in advance.

To solve partially the problem of payments I would suggest the opening of an L/C at 30 or 60 days from B/L or AWB date, asking the customer for a broad validity and for partial shipments allowed and asking to be paid for the interests, if applicable. For example I pay in Italy, as said, 14%/year, if you have a customer in Italy and you offer him let's say 90 days credit but charging the interest applicable in Japan, i.e. 1% each quarter I think that he would be more than happy to be charged for this interest rate (my example has been for Japan because I am sure of this rate, you can apply it in USA with your prevalent rates).

Other ways of being sure to be paid I do not see. If in your countries this is applicable you could demand for what we call "ACCEPTED DRAFT". In a few word against the shipment or before it you issue a draft thru your bank but you deliver only after your customer accepts the draft in his bank. This is a legal instrument in many countries and against it the banks give also loans at rates lower than usual. Again the draft can be at sight or at the terms you like and since it is accepted thru a bank gives some security.

As far as collecting bad credits from foreign countries this is a bad story. It is highly difficult and expensive. There is no Dun and Bradstreet that can help. Some local laws can be of help but it goes from country to country. If you have a problem in Italy a cause in court for collecting money can have the first session in the year of the Lord 2002!!!! (yes, twothousandandone!!) and it may go on for 3 or four years before a final judgment.

I have a bad credit in Germany, I have been paid with a check later bounced. I have spent a lot of money to go there to pay a lawyer in Germany, Thanking God words of the bounced check has reached the police, the criminal police (BKA), and now they are chasing the owner, But I have been lucky because I had the check, otherwise there was no way.

I hope to have been of a bit of help. Let me know if I can be of further assistance.

Regards (ciao in Italian) Alex

Alex Santini sant001@itnet.it ========
Tozai srl, Via Fogazzaro 105, I-36030 Caldogno, Italy
off. ph. +39-444-905115 off. fax +39-444-905108
http://www.aliasnet.it/pub/indive.htm
http://www.aliasnet.it/pub/dt
"TCHIRI, MO TSUMOREBA, YAMA TO NARU"
(=even dust, if accumulated, forms mountains)

To: bus@isbc.com
From: "Dave Weston, CDP"
Subject: Re: Question on open accounts to foreign customers -- Dave Weston

For large transactions, letters of credit are the traditional, standard procedure. However, for smaller, quick deals, letters of credit are too time-consuming and expensive.

As an international consultant, working with smaller, independent businesses, I have had excellent success with two other methods for international payments:

#1. Accepting credit cards is, by far, the easiest and simplest. Some customers won't send a credit card

number over Internet. I don't want that either. Instead I require a fax with credit card number and signature. That is better protection than email in event of chargeback. The few hundred dollars it cost me to become authorized to accept credit cards has been worth many times that.

#2. A check or international money order drawn on any USA bank in US$ can also be sent by fax. I've had excellent results accepting checks by fax for over 3 years with no problems. It gives a "hard copy" of the check maker's information and signature for your files. Once people get used to the idea of checks by fax, I think it will become widespread, because virtually every international business has a fax, and dollar-denominated money orders are easy to get at any bank.

One more method I have used as a customer, but not yet as a merchant, is "e-cash", such as First Virtual Payment Services. As a customer it has worked flawlessly every time I've used it.

Cordially,
Dave Weston, CDP * Dave@Weston-CDP.com
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From: hebb.karen@ic.gc.ca (Hebb, Karen: SIB)
To: bus@isbc.com ('bus@isbc.com')
Subject: Re: Doing Business Acro

Hi Nick, I forwarded your posting to a colleague who had these suggestions, unfortunately they only relate to Canada so I'm not sure how relevant they are to this list...

It is a good question and one that I am sure is addressed in some of the Forum for International Trade and Training Inc. (FITT) course given across Canada in Universities and Colleges. If you go on Strategis under (http://strategis.ic.gc.ca/SSG/mi01220f_pr201.sgml), you will find some reference material.

On the export side, there are several programs in place to help reduce the risk. The Export Development Cooperation has several products to cover those risks. There is a cost for these services depending on the size of the order and the risk assessment of the client.

The International section of Canadian Chartered Banks can also assist by using their network to assess foreign buyers. Canadian embassy and consulates can also often provide some comments on potential buyers.

Anyone seriously interested in exporting, could contact one of our International Trade Centers across the country. They would be in a position to provide additional guidance based on the sector and market of interest.

Karen Hebb
Strategis
http://strategis.ic.gc.ca

To: Nick Baker
From: Derk Wilken
Subject: Re: Brad's -- open accounts to foreign customers

Hello Nick,

I'm referring to the point brought up by Brad about payment terms and letters of credit. The 90 day net payment terms are not really all that usual, I think. Aside from my activities as a webdesigner for Beebop, I am part owner of a purchasing company here in Thailand. For major contracts, L/C payments are the rule as soon as trade crosses a border. It doesn't matter where a company is located, or whether they are big or not.

A little known, but interesting alternative for an L/C can be an "advance payment guarantee". You (or rather, your bank) issue a guarantee to the customer in the amount of the contract, say US$ 100,000. This guarantee becomes valid the moment your customer makes the advance payment to you. If you, the supplier, don't perform under the contract, i.e. you don't supply, you supply junk, or whatever, the customer can draw under the guarantee.

Of course, there is a risk that the customer would claim that you did not perform, even if YOU know you did. In that case you could lose your money. So you would have to build some protection into the guarantee. To go into that would make this a very long story, though. It would be different for every contract. The best would be to talk to your bank, so you'll be covered for major mishaps.

We recently had a case where our proposal for an advance payment guarantee convinced a previously reluctant government client to accept standard L/C terms for a contract.

Pffh, this has been long enough already, but I have one question to ask. Does anybody have any experience on how to get clients to pay for web design services across borders? Supplying bits and bytes is so totally different from supplying atoms and matter.

Regards,

Derk Wilken

To: Nick Baker
From: shepsm@gower.net (Sergei)
Subject: Re: Greg Lee -- Export Terms, Jargon and etc.

NCND - NonCircumvention and NonDisclosure agreement. Normally this is an agreement between you and a middleman in a deal that requires you to refrain from approaching a customer directly, bypassing this middleman. Plus you are required to keep the information confidential.

LOI - Letter of Intent (not just interest).
BCL - Never heard of it, sorry.

The best way to find it out is to ask the person who has written it. A link to acronym server you can find

at http://members.aol.com/ApLing/resource Follow the link, than type in your acronym and get an expansion in seconds! Sergei Shepelev

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To: bus@isbc.com
From: msavinon@tricom.net (M. A. Savinon)
Subject: Export terms Greg asked about certain acronyms being used in international trade.

I think I may have been the person who sent him the information that caused his confusion. Credit terms: Indicates when the buyer will open the letter of credit (LC). If opening LC at time of placing order, there is no credit involved, but there could be other options. Payment terms: When the LC is drawn on. Independently of when the LC is opened, it may stipulate that it will not be drawn on (paid by bank) in a certain period of time. For ex.: LC will be drawn on 60 days after confirmed shipping of good. In this case, the bank will not pay the LC until the 60 days have passed after the shipping documents confirm the product was shipped. NCND: Non-circumvention, non-disclosure. Are terms of a general agency agreement that are meant to protect the agent from having the seller contact the buyer directly in future orders, and thus avoid having to pay the agent his commission. LOI: As you said is the Letter of Intent whereby the buyer confirms his intention of buying the specified product under the terms specified therein. BCL: Banking Comfort Letter, is a document issued by the buyer's bank confirming the availability of the necessary funds for the completion of the transaction. The seller does not quote via the letter of credit. The seller quotes via a "soft" quote which is subject to variation or a "hard" quote or "Pro-Forma Invoice" which will secure price and other terms for a certain period of time. Based on the pro-forma invoice, the BUYER'S BANK opens the letter of credit on behalf of the buyer. A seller might require a Letter of Intent and/or Banking Comfort Letter before issuing the Pro-Forma Invoice. The agent will usually require an NCND Agreement prior to the LOI and BCL because there is a chance of both buyer and seller getting to know who the end dealers are in the transaction. If the agent is not protected by an agreement at that time, he may be left out of the negotiation, and all his precious efforts may have been futile. A serious buyer will have no objection to issuing a letter of intent (LOI) and get his bank to issue a Banking Comfort Letter (BCL). This is the seller's assurance that the buyer is serious, and that is why some sellers require the LOI and BCL before going through the trouble of issuing a pro-forma invoice. Miguel A. Savinon Dominican Republic msavinon@tricom.net

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From: INTRTRADR@aol.com
To: nick@isbc.com
Subject: Re: Question on open accounts to foreign customers & Wire Transfers

Dear Nick:

An NCND (Non-Disclosure, Non-Circumvention Agreement) is designed to allow divulging contacts and prevent your being bypassed or cirvumvented in the future. In many business situations, especially

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- **Thomas Cook to Provide Foreign Currency Online**
  Business Editors/Travel Writers. **Business Wire.** New York: Nov 9, 1998. p. 1

  http://proquest.umi.com/pqdweb?did=35774087&Fmt=3&clientId=19649&RQT=309&VName=PQD
- **The LVTS--Canada's large-value transfer system**
  James Dingle. **Bank of Canada Review.** Ottawa: Autumn 1998. p. 39 (17 pages)

  http://proquest.umi.com/pqdweb?did=36340848&Fmt=4&clientId=19649&RQT=309&VName=PQD
- **China: China ends foreign exchange swapping, strengthens unified banking forex settlement system**
  Mo Zhang. **East Asian Executive Reports.** Washington: Jun 15, 1998. Vol. 20, Iss. 6; p. 9 (6 pages)

  http://proquest.umi.com/pqdweb?did=38857019&Fmt=3&clientId=19649&RQT=309&VName=PQD
- **Banks' cross-border payment networks: Real-time change**
  Anonymous. **The Economist.** London: Nov 25, 1995. Vol. 337, Iss. 7942; p. 76 (2 pages)

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- **Chicago Group Offers Data Interchange Service Series: 14**
  BARTON CROCKETT. **American Banker (pre-1997 Fulltext).** New York, N.Y.: Apr 21, 1994. Vol. 159, Iss. 76;

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with brokers that are basically trying to make money by introducing a party with something to sell to a party with a desire to buy, such protection is important. This is magnified when there is a broker chain between the principals. Unfortunately, many people will sign NCNDs and then later ignore the agreement. It is said that NCNDs are not even valuable as toilet paper, since the fax paper that they usually are written on is too slippery. What is more important is that you pick and choose who you do business with and steer clear of anyone that you cannot trust. When doing business with strangers over the internet you have to take chances with unknowns. If you think that someone is circumventing you, don't do any business with them again. If you have a signed NCND and you find out that you have been circumvented at least you have a document that can be used as the basis of a legal action, if you can prove that you were circumvented subsequent to the signing of the document. Without a signed NCND you will have no basis for legal action. Wayne R. Steele Trustee for Private Signatory Precious Metal Buyer

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Contact Information:

E-mail SB@isbc.com
International Small Business Consortium
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Norman, Oklahoma (OK) 73072 USA

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The Economist

Banks' cross-border payment networks: Real-time change

Anonymous. The Economist. London: Nov 25, 1995.Vol.337, Iss. 7942; pg. 76, 2 pgs

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Subjects:	Banks & banking, Computer applications, International
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Fast account to account

Full Text (860 words)

WHETHER sending or receiving payments across borders, banks often charge too much or take too long--or both. One study last year found that European banks overcharged for over a third of urgent transfers. Thankfully, new payments **networks** are starting to offer quick, reliable and more competitively priced service. Given time, these could pose a threat to traditional bilateral (or correspondent) agreements between individual banks and to the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the global **network** that processes most large international payments.

One upstart gaining credibility is the Inter-Bank On-Line System (IBOS), which was founded in 1991 by Britain's Royal Bank of Scotland and Spain's Banco Santander. After a slow start, it recently scored a double coup: on September 22nd it signed up ING, a Dutch bank, and on November 6th America's Chase Manhattan became a member. These global banks have extended IBOS'S reach to America and Asia, and their inclusion has also excited the interest of oncesceptical competitors.

What is the system's attraction? The answer is that instead of taking many days and bits of paper, the norm in correspondent banking, account-to-account payments in IBOS can be completed in under seven seconds, or more or less "real-time". It claims to be a cost-effective alternative to opening an expensive international branch **network**. The system's executives like to refer to its members--now 11 banks from nine countries--as a single "virtual bank". Charles Mallis of Chase, which is merging with Chemical, a big American rival, says that this ability to "share"

branches was a big attraction to the bank, even though it already has the world's largest correspondent **network**.

IBOS bills itself as more than simply a quick-payments service. It wants to develop into a platform for all sorts of cash-management products, particularly for multinationals. Sean Verity, its chief executive, says that there are also plans to license the system's technology, so that banks anywhere can use it as a platform for their own independent payment associations. And its members think that its advanced technology could help them to steal a march in the move to the next stage of global electronic commerce-payments using smart cards, electronic cash and so on.

However, the system is still tiny compared with SWIFT, which links thousands of institutions and processes more than 2m transactions a day. Traffic across the **network** has climbed steadily since it was set up almost 20 years ago (see chart on next page). By contrast, IBOS'S payments volumes are still small (it will not say how small) and it has still to convince many large companies of its worth, especially those that do not already bank with its members.

IBOS claims that it is not a direct threat to SWIFT because the two are fundamentally different in several ways. For instance, the former is a decentralised cash-management technology which links different banks' branches directly, whereas all traffic for its bigger rival must pass through a central hub in Brussels.

Nevertheless, some of SWIFT'S recent initiatives look defensive. For one thing, it is trying to set up its own real-time payment service with a group of member banks. It has also developed a new service for non-urgent payments. If it can get enough banks to sign up, it might create a giant **network** that at least guaranteed customers certain standards, such as transfers in under six days. That remains a big if. Many of its member banks set their own standards, often through a hotch-potch of bilateral agreements. Getting them to agree on harmonised standards will be difficult.

Clearing and climbing **international payments** traffic **over** the SWIFT **network**, m transactions

That is not a problem for IBOS. One of its fans is the European Commission, which has long campaigned to improve inter-bank payments. It has drawn up a directive aimed at forcing banks to stop overcharging and to reimburse lost interest if transfers are slow. IBOS'S banks were among the few to applaud the directive. Alessandro Dona, a commission official, says that many banks resist change because they profit from the existing, creaky infrastructure.

That resistance is slowly being challenged. Though by far the fastest alternative **network**, IBOS is not the only one. Other alliances have emerged in recent years. Among them are Relay, a tie-up between Germany's Commerzbank, Britain's National Westminster, France's Societe Generale and Credito Italiano of Italy; Tipa-Net, which links co-operative banks in six European countries; and Eurogiro, which connects postal banks all over the European Union. Central Europe even has its own regional **network**, albeit one run from Brussels. The two-year-old Clearing Bank Association clears ecu-based trade-related payments between eight Central European banks. Link-ups between European savings banks and national clearing houses are also planned.

This, it would appear, is just the first stirring of a large-scale drift away from bilateral correspondent banking towards flexible, price-competitive payments clubs. Mr Verity expects that "three or four" real-time competitors to his system will emerge by the end of the decade. Others think that alliances between national clearing houses will become the standard. Whatever the outcome, a free market in payments might one day ensure that all bank customers get value for money. Now that would be a novelty.

Document View

Thomas Cook to Provide Foreign Currency Online

Business Editors/Travel Writers. **Business Wire**. New York: Nov 9, 1998. pg. 1

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Abstract (Document Summary)

(BUSINESS WIRE)--Nov. 9, 1998--Thomas Cook, one of the world's leading international travel and financial services organizations, today launched "Currency Online" on the **Internet**. Currency Online enables customers to order foreign exchange twenty-four hours a day from their homes or offices.

Thomas Cook plans to work with leading edge financial institutions and business partners to enable them to provide Currency Online directly to their customers within their own sites. Currency Online is an easily implemented **Internet** application whereby Thomas Cook provides "partners" with a snippet of HTML which is placed on a page of the partner's **Internet** site and which calls a JAVA applet resident on a firewall protected Thomas Cook server. As the calculator is Java based, all of the conversion calculations occur locally, within the partner's web page on the user's browser. If a customer then decides to place an order, a secure new window is popped open, which contains the easy to complete order form. When the order is complete the window can be closed, leaving the user to continue browsing through the partner's site.

Full Text (747 words)

TORONTO--(BUSINESS WIRE)--Nov. 9, 1998--Thomas Cook, one of the world's leading international travel and financial services organizations, today launched "Currency Online" on the **Internet**. Currency Online enables customers to order foreign exchange twenty-four hours a day from their homes or offices.

In order to help customers better understand their foreign exchange needs abroad, Currency Online also gives customers use of a currency converter. The converter is updated with the latest exchange rates at least once a day, so customers can calculate exactly how much foreign currency they will need for their trip. In addition, users can take advantage of a travel tip section, giving them information on their chosen destination, which they can print and take on their travels.

"At Thomas Cook, we are committed to offering customers a choice of ways to access our products and services. Many people leave buying their foreign currency until the last minute, as there are so many other preparations to take care of before a vacation. Currency Online provides people with an ideal means to determine in advance how much money they'll need for their trip, and to then buy their foreign currency online, at their convenience, and have it delivered directly to their home or place of work," said Gary McDonald, President, Thomas Cook Financial Services, The Americas.

Thomas Cook is making this facility available to users accessing Thomas Cook's own North American **Internet** site, www.us.thomascook.com, as well as Thomas Cook's first "partner" site, The British Tourist Authority's US site, www.usgateway.visitbritain.com, which provides the US traveler to Britain with a wealth of valuable travel information.

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"We wanted to create an application that was simple for the consumer to use and valuable when added to a partner company's site. The calculator adds enormous value especially to travel-oriented or financial services sites whereby users can convert currencies and get an up to date rate," commented Tracy Hammock, Vice President, Consumer Futures, Thomas Cook Financial Services, The Americas.

"In implementing this solution we have been able to leverage the leading edge technology currently in place in our North American Call Centers to seamlessly integrate **Internet**-based order processing and fulfilment," Hammock continued.

The development has been a global effort, with marketing input from the Thomas Cook Head Office in London, England and The Americas Region office in Toronto, Canada, infrastructure input from Call Centers in the United States and Canada and application development and design by the Toronto based web developers, **Internet** Marketing Associates and Corelan Communications.

To ensure that Thomas Cook continues to deliver value to customers, a market research survey has been incorporated into the application, asking willing users to comment on Currency Online. To encourage response, the survey carries a Free Prize Drawing whereby visitors to the site can win up to $1,000 as a first prize plus four runner up prizes of $500. The prizes, MasterCard Travellers Cheques from Thomas Cook, will be drawn just before Christmas.

NOTE TO EDITORS

Thomas Cook has three core business lines - Travel, Financial Services and Global Services - and has been serving customers for 157 years. Today the Group provides services at more than 3,000 locations in more than 100 countries, and employs over 15,000 people who serve some 20 million customers a year. Thomas Cook is the one of the world's largest supplier of travelers checks and owns the world's largest **network** of retail foreign exchange bureaus.

Currency Online adds to Thomas Cook's portfolio of foreign exchange products, which includes the Virtual Trading Desk (VTD), a business solution that allows customers to make **international payments over the Internet**. The Virtual Trading Desk has received several awards, including British Telecom's 1998 Award for

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The LVTS--Canada's large-value transfer system

James Dingle. **Bank of Canada Review**. Ottawa: Autumn 1998. pg. 39, 17 pgs

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Abstract (Document Summary)

The Large-Value Transfer System (LVTS) is an electronic **network** for sending and receiving large-value payments. It is expected to become operational in the first half of 1999. Major chartered banks and other large deposit-taking institutions provide access to the system for their clients in the financial, corporate, and government sectors. Canada's LVTS exceeds world standards for risk control in large-value transfer systems. This is achieved through netting, bilateral and multilateral credit limits, collateral, loss-sharing procedures used in the event of a default, and, as a last resort, a guarantee by the Bank of Canada. The LVTS gives participating institutions certainty of settlement for their LVTS positions every day, even if one or more participants default. This assurance greatly reduces systemic risk. The LVTS supports finality of payment. Finality is highly desirable when the amount of the payment is substantial, or when exact timing is critical.

Full Text (6342 words)

The LVTS is an electronic **network** for sending and receiving large-value payments. It is expected to become operational in the first half of 1999. Major chartered banks and other large deposit-taking institutions provide access to the system for their clients in the financial, corporate, and government sectors.

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The LVTS gives participating institutions certainty of settlement for their LVTS positions every day, even if one or

more participants default. This assurance greatly reduces systemic risk.

The LVTS supports finality of payment, that is, it makes the funds unconditionally and irrevocably available to the receiver. Finality is highly desirable when the amount of the payment is substantial, or when exact timing is critical.

Background

Rationale

By their very nature, large-value payments using cheques entail risk. A significant amount of money is being transferred from one party to another, usually with the involvement of two financial institutions. There are two key risks related to the transfer. The payee could discover that the payor did not, in fact, have sufficient funds to make the payment. The payee's financial institution could receive notice of the transfer and allow the payee to use the money, only to discover that the payor's institution had been declared in default that day and would not settle-i.e., make good on the transfer. All modern payments systems attempt to address these risks.

Computer/communications technology has increasingly been used to control the risks in large-value payment systems. Both the private and public sectors have been working to bring the power of real-time processing to bear on the problem of risk control. Moreover, their efforts to apply new technology promise gains in areas beyond risk control, particularly with respect to processing efficiency. For example, transactions for which certified cheques have traditionally been used can be handled both securely and more efficiently with a modern large-value transfer system. The payee need not request certification (because the receipt of an electronic transfer is final), and the payee does not have to deposit an incoming cheque in a bank (because the funds are already there).

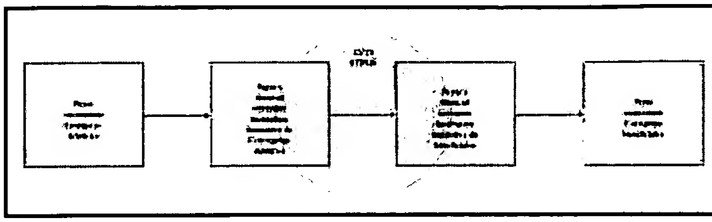
What is the LVTS?

The LVTS is an electronic **network** for sending and receiving large– value payments. It is expected to become operational in the first half of 1999. Although the principal users will be in the financial, corporate, and government sectors, certain large payments by individuals are also likely to move through this system in the near future. Since the LVTS is expected to carry the great majority of the value of all payments in Canada, it should be considered the core of the national payments system. (A comparison between the LVTS and certain large-value funds– transfer systems in other countries is found in the Appendix.)

To grasp the various elements involved in the electronic transfer of funds, consider a manufacturing corporation that wants to pay a supplier. The manufacturer is, in all likelihood, linked electronically to its bank (or other deposit--taking financial institution) for a number of purposes such as the receipt of current information on its accounts and financial market quotations. To a large extent, these electronic linkages will be used to initiate and authorize LVTS transfers. In such cases, an officer of the corporation gives its financial institution the name of the payee (the supplier), the payee's financial institution and account number, the dollar amount of the transfer, and the effective date. Before sending the transfer, the payor's institution verifies that the payor has sufficient funds in its account to cover the payment.

Next, we focus on the relationship between the two financial institutions carrying out the transfer to the supplier. Here we are dealing with the "participants" of the LVTS, all of which are members of the Canadian Payments Association (CPA).1 The participants are institutions that serve numerous large clients, or that are active on their own account in the securities markets and the foreign exchange market. LVTS participants are connected to one another through a telecommunications **network** provided by an international co-operative called SWIFT.2 This **network** offers a high degree of security supported by encryption and rigorous user-access procedures.

Before the transfer of funds to the supplier can move across the LVTS **network** and be recorded as a gain for the receiving participant, a number of calculations and risk-control tests are performed by the central computer supporting the LVTS. For example, multilateral net positions-the value of payments received less payments sent-are continuously calculated (using various concepts described later in the section on the risk-control structure). If the net position of the sending participant is close to zero or even negative, and if the particular transaction would push the negative position of that participant beyond a critical "cap" amount, that payment will be rejected or placed in a waiting queue. If, on the other hand, the transfer succeeds and augments the position of the receiving participant, the payee's account can immediately be credited without risk. The ability to do this without fear of loss is a direct result of the certainty of settlement in the system, i.e., that LVTS transfers are never reversed. Consequently, finality of payment is supported for both the participating institutions and for their clients.



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The relationship between the receiving participant and the supplier corporation (the right-hand side of the diagram) is essentially beyond the realm of the LVTS, falling once again into the proprietary area involving the deposit-taking institutions and their clients. But the presence of the LVTS is a major force for change, partly because it becomes possible for a receiving participant to inform a payee in a timely fashion (and perhaps in a fully automated way) about the receipt of a final payment and the current level of a working balance. This payment-related information will be valuable to corporate treasurers; for example, it will be particularly useful in closing securities and real estate transactions.

Why is the LVTS being built?

One important reason for constructing the LVTS is a desire to address the risks associated with the existing, and still largely cheque-- oriented, payments system. (See Box 1.) An institution that is exchanging cheques in the daily clearings operated by the CPA3 may record a net gain on a particular day and firmly expect to experience a corresponding credit in its settlement account at the Bank of Canada when the clearing cycle concludes on the following business day. But there is always a slight chance that one of the other institutions will default and be unable to settle a negative clearing position. In this event, the still-viable institutions are obliged to cover the shortfall.4 Thus, there is no certainty of settlement in the existing system. Clearing participants have to wait until at least noon on the next business day to be sure that the inflow of funds reflecting a clearing gain has in fact occurred. In contrast, within the LVTS, there will be complete certainty of settlement on a payment-by-payment basis, and settlement risk for the participating institutions will be eliminated.

Without certainty of settlement, there is risk both to the payee and to the payee's institution. The payee client may be given immediate use of the funds but only on a provisional basis. If the institution on which the item is drawn defaults, the deposited item must be returned through the clearings if it is still in the possession of the defaulting institution, and the provisional credit to the client's account will be reversed (if possible). Similarly, if the payor has insufficient funds in its account, the deposited item will be returned through the clearings, and the provisional credit will be reversed (if possible). In other words, there is no finality of payment. With the LVTS, however, each transfer is final as it occurs. The receiving institution does not take on any risk as it makes an irrevocable credit to the account of the payee. Correspondingly, the payee knows that it has received funds with finality, once it is notified of the transfer.

The lack of certainty of settlement in the traditional clearing arrangements has a second and significant implication- it increases systemic risk. This is the risk that the default of one clearing institution will lead to the default of a second, which will in turn lead to the failure of a third, and so on. As noted earlier, the CPA bylaw governing the existing clearings system requires participating institutions to cover a share of the shortfall of a defaulting clearer. While this approach has the advantage of distributing the loss widely among the surviving clearers, it could conceivably be the mechanism that starts a chain of defaults because the participants have no foreknowledge of the amount or the distribution of the shortfall involved, and thus face a risk that is virtually unmanageable. With the LVTS, the maximum potential burden for each participant is known at all times, and the institutions have both the information and the procedures to manage this exposure and keep it at acceptable levels. The capacity of each institution to fulfill its settlement obligation is reinforced by the advance pledging of high-quality securities to the central bank. Thus, the LVTS makes a major contribution to reducing systemic risk.

The certainty of settlement and finality of payment that the LVTS provides are highly valued in the international context (BIS 1996). For example, global foreign exchange transactions produce payments amounting to hundreds of billions of dollars in many national payments systems every day. Participants may be paying out value via a payment system that provides finality of payment while expecting to receive value over a system that provides only conditional availability of funds. The participants are thus exposed to substantial settlement risk. The LVTS ensures finality of payment for the Canadian dollar leg of foreign exchange transactions.

Concern on the part of central banks regarding the exposure of commercial banks to settlement risk in foreign

exchange transactions led to the development of a set of standards under the auspices of the Bank for International Settlements (BIS 1990b). The "Lamfalussy" Standards (named after the BIS general manager who chaired the Group of Ten working group) initially addressed settlement risks in crossborder and multicurrency netting schemes, but central banks soon applied them to domestic large-value transfer mechanisms as well. For example, Standard IV states that systems should, at a minimum, be capable of ensuring timely completion of the daily settlement in the event of the failure of the participant with the largest single net debit position. The LVTS is designed to exceed this international standard. (See page 47.)

Finally, national payments systems that do not support finality are less attractive to savers and investors for the full range of financial transactions. The construction of the LVTS and the provision of finality thus help to maintain Canada's international competitiveness in financial services.

Who built the LVTS?

The LVTS is the largest project ever undertaken by the Canadian Payments Association, involving over 10 years of work by the CPA's board and by numerous committees. Approximately $15 million was spent to develop the system, financed by the CPA member institutions as part of their annual dues. The LVTS project is a good example of how the CPA fulfills its statutory objective to plan the evolution of the national payments system.

As the details of the LVTS risk-control devices became clear in the CPA plans, the board met to discuss them with the four relevant federal regulatory authorities-the Office of the Superintendent of Financial Institutions, the Canada Deposit Insurance Corporation, the Bank of Canada, and the Department of Finance. After due consideration, these authorities wrote to the Chairman, approving the proposed devices and the pledging of collateral involved. The CPA subsequently sent a description of the risk-control devices to provincial regulators for their comments.

The CPA's member institutions then developed the LVTS By-law-- the formal statement governing the relationship among the LVTS participants, including the risk-sharing commitments of those CPA members that are participants in the new system. This bylaw governs the clearing and settlement arrangements relating to all payments made through the LVTS, as well as the conduct of all persons connected with the operation and administration of the LVTS. The bylaw was approved by the federal Cabinet on 2 April 1998 and becomes effective upon the entry into operation of the LVTS.

The clearing and settlement process within the LVTS gains additional legal force through the Payment Clearing and Settlement Act. Under this legislation, the Bank of Canada may, with the approval of the Minister of Finance that it is in the public interest to do so, designate a clearing and settlement system as falling within Bank oversight. Following designation, the rules with respect to the clearing process within the LVTS will be immune to legal challenge, and this in turn will support the certainty of settlement and finality of payment of LVTS transfers. After the designation, the Bank of Canada will provide ongoing oversight of the LVTS as part of its statutory responsibility to help ensure that systemic risk is appropriately controlled.5

Operational framework

Access criteria

The criteria under which an institution may become a "participant" in the LVTS are quite open. It is first necessary to be a member of the CPA. The participant must also use the SWIFT telecommunications network in Canada and must have adequate backup capability for its LVTS operations. The Bank of Canada must also confirm that the institution has opened an account for settlement purposes and that it has entered into agreements relating to taking loans from the central bank and to pledging the appropriate collateral.

The LVTS access criteria omit any references either to the size or the financial condition of participants. This is an important indication of the open nature of the system's membership. In contrast, access criteria for several clearing mechanisms in Canada and abroad involve minimum-- volume requirements or measures of financial performance such as bond ratings or capital. Such criteria are understandable when the procedures for handling a default include an element of unavoidable risk-sharing among the participants. The LVTS risk-control structure (described in the next section) does involve an element of risk-sharing, but it also opens up ways for participants to minimize or eliminate this exposure by prudent business practices. As a result, the CPA was able to avoid access criteria based on measures of size or financial performance. Sixteen institutions will be participants at the LVTS opening, which compares with 13 that are direct clearers in the arrangements supported by the CPA's Automated Clearing

Settlement System.6

Risk-control structure

The risk-control structure of the LVTS rests on four elements:

The position of each participant (netting outflows against inflows) is calculated on a payment-by-payment basis, in real time, by the central computer supporting the system.

Participants' net debit positions are subject to ceilings.

The participants have together prepledged, to the central bank, appropriate securities with a value sufficient to cover the largest single permitted net debit position, thus ensuring settlement for the participants even in the event that one of them defaults.

The Bank of Canada has agreed to guarantee settlement in the extremely unlikely circumstance that the sum of the exposures of failed institutions in the LVTS exceeds the prepledged collateral as a result of the unanticipated failure of more than one participant on the same day during LVTS operating hours.

These four elements provide the participants with certainty of settlement, which in turn, permits the institutions to offer finality of payment to their customers. With these four elements, the LVTS exceeds the requirements of the Lamfalussy Standards.

A noteworthy characteristic of the risk-control structure is that for each transfer of funds, the sending participant has a choice between the two types of payment known as Tranche I and Tranche 2. Each type has its corresponding risk-control limits.

Tranche 1

A participant can move into a net debit position as a result of this type of transfer as long as the position is no greater than the amount of collateral that the institution has pledged specifically for Tranche I activity. If the participant should default in the course of that day, this collateral will be used to cover any net negative position in this category. For this reason, Tranche 1 payments have become known as the defaulter pays type within the LVTS. It is envisaged that they will be used for payments associated with the settlement activities of clearing houses in the securities and foreign exchange areas. They would also allow a participant experiencing financial difficulty, and losing the confidence of the other participants and unable to use Tranche 2, to continue to operate in the LVTS as long as its acceptable collateral holds out.

Tranche 2

These payments are expected to make up the great majority of the traffic on the LVTS, principally because of savings in collateral relative to Tranche 1 operations. Each participant makes a judgment each morning about the creditworthiness of each other participant. This takes the form of a bilateral net credit line; i.e., the largest net exposure that it is prepared to accept vis-a-vis that institution on that day. In addition, each participant (as a sender) has a multilateral net debit cap, calculated as the sum of all bilateral lines extended to it, multiplied by a constant percentage (which is initially being set at 30 per cent).

The risk-control structure for Tranche 2 activity has been described as survivors pay because of the risk-sharing involved. Each participant has a potential additional settlement obligation (ASO) that must be fulfilled if one of the group defaults during the day. Each ASO is a share of the dollar amount of the net debit position of the defaulter, where the proportion is the bilateral line of credit extended by the participant to the defaulter that morning, divided by the sum of all the bilateral lines extended to that institution. The maximum ASO for each participant need not exceed the largest line that it has extended, times the constant percentage noted above, in order to ensure that the largest possible single default can be covered by the surviving participants handling Tranche 2 transfers. Participants are required to pledge collateral in this amount.

A participant experiencing financial difficulties might see its bilateral lines contracting and its Tranche 2 multilateral

net debit cap rapidly diminishing. In such circumstances, the participant could send transfers of this type only after inflows from other participants had created a net positive position. (Sending transfers of the Tranche 1 type, on the other hand, would still be possible.)

At the close of the LVTS day, each participant must settle at the Bank of Canada for any net debit amount that remains when its Tranche 1 and Tranche 2 positions are added together. This may leave a net negative position, and may involve borrowing that amount from the Bank of Canada overnight, on a fully collateralized basis, at the Bank Rate. Typically, however, participants will aim for a net closing position of zero, and normally there will not be deficits or surpluses on settlement accounts. There are three reasons for this. First, the central bank intends to offset government sector LVTS flows that would otherwise move the sum of all the settlement accounts of private sector participants away from zero. Second, participants in deficit will normally be able to borrow from those participants in surplus at terms better than the Bank Rate and, hence, will typically do so to square their positions. Third, there is a pre-settlement trading period during which participants can conduct such transactions. (See Box 2.)

Should a participant be unable to settle (perhaps because a regulatory authority has closed the institution), then the ASOs will be called upon, using the collateral pledged by the full set of participants. The collateral of the failed participant pledged for Tranche 1 (if any) and for Tranche 2 activity will be used to meet its unfulfilled obligation. Then, if necessary, the collateral of the surviving participants, pledged in the context of Tranche 2, will be used.

Interactions with other financial structures

The LVTS will contribute significantly to the soundness of other parts of the Canadian financial system. For example, the LVTS will be used by the participants in the Debt Clearing Service (DCS), which is operated by the Canadian Depository for Securities Limited. At the close of business each day, those DCS participants that are required to make payments to the depository will send the payments via the LVTS to the Bank of Canada, which will be serving as the settlement agent or "banker" for the DCS. Conversely, all participants that are entitled to receive payments will receive them from the Bank of Canada (on behalf of the depository) via the LVTS. The ability of the DCS participants and the central bank to use the LVTS to receive and send such final payments promptly and efficiently, with no overnight risk (as exists with cheques), will imply a major strengthening of the risk-containment mechanisms in securities markets.

Similarly, the LVTS will significantly reduce the settlement risk in foreign exchange transactions involving Canadian dollars. Since the LVTS eliminates the next-day settlement associated with cheque transactions, it substantially cuts the duration of risk for receivers of Canadian dollars. Moreover, the LVTS provides the receiver with unconditional and irrevocable availability of funds once the payment passes the tests in the risk-control structure. Large-value payments systems capable of providing intraday finality, when used for the delivery of both currencies involved in a foreign exchange transaction, can eliminate exchange-settlement risk. For example, CLS Services Limited, a company formed by a group of commercial banks from eight countries, is developing a continuous-linked settlement mechanism that will use the LVTS and major payments systems in other countries to achieve this goal.7

In many of these interactions between the LVTS and other financial structures, the use of final payments at the crucial settlement stages of daily operating cycles means that, as soon as these cycles are complete, there is no longer any settlement risk. In addition, the increased safety within the various structures implies a major reduction in systemic risk for the whole financial system.

How the LVTS will be used

The opening of the LVTS in the first half of 1999 will mark the beginning of the migration of large-value (and other critical) payments away from paper media, such as cheques and drafts, and towards electronic transfers. This migration is highly desirable for two reasons. First, the more payments that flow through the risk-proofed electronic system (as opposed to the existing clearing system with the uncollateralized and unmanageable exposures implied by its survivors-- pay default-sharing rule), the more the systemic risk in the Canadian payments system declines and is contained. Second, participants expect that the greater the degree of migration, the greater will be the economies with respect to the necessary amounts of collateral.

The speed of the migration will be a function of the perceived costs and benefits for users. Costs per LVTS payment are expected to be comparable to the fees charged today for international wire transfers. Benefits will be derived from the full certainty that no default among the participating financial institutions (or among payors) will

lead to the reversal or loss of an incoming payment. Other benefits that will flow from the introduction of the LVTS include the payment information services that LVTS participants will develop for their clients.

The migration of payments to the LVTS will be immediate in the case of transactions routed over the Interbank International Payments System (IIPS).8 These transactions involve correspondent banking transfers, third-party international payments, and the settlement of transactions in the domestic interbank deposit market. The value of these transfers was found to be $87 billion per day in a recent survey. The average number of transfers involved was almost 12 thousand per day. The LVTS will carry all these types of traffic; the IIPS will be closed for Canadian dollar payments.

Certain government sector flows will also move immediately to the LVTS. For example, the money directed to the winning participants in the daily auction of Receiver General term deposits will be regularly transferred by the LVTS. On a peak day, this can exceed $4 billion. And the periodic transfers of funds from the federal government to provincial governments, which exceed $500 million on particular days, will also be on the new system.

The wide variety of private sector flows (other than those previously on IIPS) will migrate to the LVTS more gradually. The potential order of magnitude involved may be estimated by referring to the "large" stream in the traditional clearing procedures accounted for by the CPA's Automated Clearing Settlement System. Early in 1998, the value of "large" payments moving via cheques averaged about $60 billion a day. Some 23 thousand payments per day were involved. Since the "large" stream is defined as transfers over a fairly modest minimum of just $50 thousand, one would expect several years to pass before even half of these private sector payments migrate to the LVTS. On the other hand, certain flows-for example, those involving real estate transactions-- could shift relatively quickly to the LVTS because of the attractiveness of finality of payment to both payors and payees.

The central bank and the LVTS

The Bank of Canada has been heavily involved with the LVTS project from the earliest discussions within the CPA board concerning the need for such a mechanism, through the design and approval stages and, most recently, in the move to full LVTS operation. The ongoing involvement of the central bank has three aspects: the use of the LVTS in the implementation of monetary policy; ensuring that the risk-control mechanisms are adequate (including the guarantee); and the provision of key services relating to collateral.

The Bank of Canada devoted considerable time and effort to studying the implications of the LVTS for the implementation of monetary policy. The objective was to choose a set of instruments and procedures that would leave the Bank with at least the same degree of control over short-term interest rates in the LVTS context as it had within the existing payments system. Two discussion papers (Bank of Canada 1995-96, 1996) were published, and meetings were organized to obtain input from the directly clearing members of the CPA and from the investment dealers. The outcome of this process is described in "A primer on the implementation of monetary policy in the LVTS environment," on page 57 of this Review.

The Bank of Canada also took the lead on behalf of the federal regulatory authorities in the discussions with the CPA regarding the risk-- control mechanisms to be built into the LVTS, and will oversee the system pursuant to the Payment Clearing and Settlement Act. The Bank's oversight activities seek to verify that the LVTS adequately addresses systemic risk. The Bank is also confirming the readiness of the new system by requesting that the CPA obtain an audit as specified in Section 5900 of the Canadian Institute of Chartered Accountants Handbook. In the future, the Bank may request the provision of statistical information from the CPA, may require notice of expected changes in bylaws, rules, and procedures, and may obtain any other information it requires.

As noted earlier, the Bank of Canada has guaranteed that the daily settlement process will conclude satisfactorily, even in the extremely unlikely situation9 involving the unanticipated default, during LVTS operating hours, of two or more participants (and a total shortfall so large that the amount of prepledged collateral proves insufficient to allow settlement). This means that any participant that has enjoyed a net gain in its LVTS funds position from transactions with the defaulters is guaranteed that it will see the corresponding increase in its settlement account at the Bank of Canada that evening. However, the central bank guarantee does not involve moral hazard (i.e., an incentive for the participants to undertake more risk than they might otherwise take) because of the survivors-pay procedure for handling the first default on any day. This well-defined risk must be considered by the participants in their decisions about the bilateral lines they extend to each other participant, lines that may be revised each day. Since participants cannot be certain which other participant (if any) will default that day, they must be prudent and make careful decisions with respect to all the bilateral lines they extend. The central bank guarantee does not alter

these decisions.

Collateral is central to risk control in the LVTS, and the Bank of Canada performs several functions with regard to collateral. First, the central bank is the entity to which the LVTS participants pledge their securities. The list of asset types acceptable for pledging is established by the Bank.io Moreover, the central bank will provide the CPA with valuations of the securities when they are pledged, and the valuations in turn will be used to ensure that the value of the collateral at least covers the various debit caps and additional settlement obligations. A specialized computer system (the Collateral Valuation and Tracking System) has been built by the Bank to monitor and value the collateral pledged by the participants in the LVTS quickly and accurately. Finally, the central bank will provide a new form of deposit on its books, the Special Deposit Account (SDA), that can be opened by participants and serve as collateral for their LVTS operations. Participants can finance their SDA in the money market at approximately the overnight rate and earn a rate of interest from the central bank that is only slightly lower. Thus, the SDA innovation reduces the cost of collateral in the LVTS, a welcome development for the major participants and, indirectly, a benefit to their clients.

[Sidebar]
This article was prepared by James Dingle of the Department of Monetary and Financial Analysis. Mr. Dingle is also the Deputy Chairman of the Canadian Payments Association.

[Sidebar]
Box 1: Payment by cheque

[Sidebar]
When a payee receives a payment by cheque and deposits it, there is always the possibility that, after a day or two, the cheque can be returned, and the corresponding credit in the payee's account can be reversed. Consequently, the payment is not final.
The most common reason for a returned cheque is insufficient funds in the payor's account. On much rarer occasions, the institution upon which the cheque is drawn could have been declared insolvent by a regulator. In either case, the cheque must be returned, and the payee must go back to the payor and obtain a new payment item.

[Sidebar]
Box 2: LVTS daily operating schedule

[Sidebar]
7 a.m. to 8 a.m. Eastern Time. Participants set their sender net debit caps for Tranche 1 activity and their bilateral lines for Tranche 2 transfers. The maximum ASOs are then calculated. Appropriate collateral is pledged to the Bank of Canada, and the Bank provides an evaluation of this collateral to the CPA. The collateral must be sufficient to cover the largest possible net debit position of any single participant.
. 8 a.m. The LVTS opens for payment transactions.

[Sidebar]
8 a.m. to 6 p.m. Participants send transfers to one another, either on their own account or for third-party clients. Receivers make incoming funds available to payees. Participants track their Tranche 1, Tranche 2, and overall positions throughout the day so they can respond if they are nearing a cap amount. They may adjust their Tranche I limits (and increase their pledged collateral if needed). They may also reduce any bilateral lines extended to other participants, although this does not change the calculated shares of any loss.
6 p.m. The LVTS closes for third-party transfers.

[Sidebar]
6 p.m. to 6:30 p.m. Pre-settlement period during which participants may enter into transactions with each other designed to even out "long" and "short" LV rS positions and reduce any need to borrow from the central bank overnight.

[Sidebar]
6:30 p.m. to 8 p.m. Settlement period during which the Bank of Canada enters the multilateral net position (either a credit for a gain, or a debit for a loss of funds) of each participant into its settlement account at the central bank. The entries in the settlement accounts are final. The Bank of Canada makes every effort to complete the settlement procedures by 7:30 p.m. so that unused collateral can be released to the participants by 8 p.m.

[Footnote]
1. Under the Canadian Payments Association Act of 1980, all CPA members must be regulated, supervised, deposit-taking financial institutions. (In most cases they are also members of a federal or provincial deposit-insurance scheme.)
2. Society for Worldwide Interbank Financial Telecommunications. For a description, see BIS (1992).

[Footnote]

3. A description of the clearing procedures is found in BIS (1993), 59-62.

[Footnote]
4. According to Section 20 of the CPA Clearing By-law, the still-viable institutions must cover a share of the defaulter's shortfall, the share being proportional to their net clearing gains vis-a-vis the defaulter in that clearing cycle. The amount of the shortfall is calculated after the return, through the clearings, of any payment items payable by the defaulter that are still in its possession.

[Footnote]
5. For additional detail, see Bank of Canada (1997) and Goodlet (1997).
6. The list of direct clearers is published on page S 123 of this Review. All will be LVTS participants. The additional institutions preparing to participate in the LVTS are ABN AMRO Bank Canada, Bank of America Canada, and Banque Nationale de Paris (Canada). More institutions may choose to become participants in the future.

[Footnote]
7. To settle both sides of all transactions on the same calendar day, payments systems in the Western Hemisphere must open very early in the morning to allow overlaps with the business hours of payments systems in the Far East and Europe. This, in turn, will permit a receipt and payment of funds in any two major currencies to occur in the same narrow time frame. The CPA is committed to opening the LVTS as early as 12:30 a.m. when the continuous-linked settlement mechanism becomes operational.

[Footnote]
8. A description of the IIPS can be found in BIS (1990a).

[Footnote]
9. The extremely unlikely situation must involve at least two unanticipated defaults of participants, all occurring on the same day and within LVTS operating hours, with Tranche 2 net debit positions adding to more than the collateral prepledged for Tranche 2 purposes by all the participants. Anticipated problems can be expected to result in sharp reductions of any bilateral lines of credit still extended to the participants in difficulty, and an increasing reliance by these institutions on Tranche I (hence defaulter-pays) operations. The Bank of Canada guarantee is not relevant in the context of Tranche I payments because such transfers are fully collateralized by the sender.
I0. The list includes marketable securities issued by or guaranteed by federal or provincial governments, as well as National Housing Act Mortgage-Backed Securities (NHA MBS).

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[Appendix]
Appendix:

[Appendix]
A comparison of the LVTS and RTGS systems

[Appendix]
The LVTS differs in one major respect from most of the large-value payment mechanisms that exist or are being built in other countries-it is a net settlement system, as opposed to a gross settlement system. As in most real-time gross settlement (RTGS) systems, in the LVTS the participants can monitor their positions in real time, but in contrast with most RTGS systems, they must wait until the end of the day before their overall (net) gains or losses of funds are officially recorded on the books of the central bank. In most RTGS systems, transactions either increase or decrease positions at the central bank as the day proceeds. The LVTS guarantees that the appropriate movement in central bank balances will occur in due course later in the day.

Both the LVTS and RTGS systems track the transactions and balances of each participant in real time as the day proceeds, and both constrain participants' positions with reference to risk-control parameters. The LVTS is distinctive in this regard because of the Tranche 1 and Tranche 2 types of payments; the former encourages a broad set of participants, while the latter economizes on collateral.

Since both the LVTS and RTGS systems provide certainty of settlement throughout the day, both support the provision of intraday finality of payment by participating institutions to their clients.

Most real-time gross settlement systems place a lower risk exposure on the central bank than the LVTS. This follows from the fact that the RTGS systems are typically designed to handle a default in a "defaulter-- pays" fashion. (For example, the net debit position of the defaulter could be covered by the defaulter's collateral.) The Bank of Canada is exposed in the LVTS in two ways: the Bank is a full participant in the system and will have a potential Additional Settlement Obligation in the context of its Tranche 2 operations; moreover, the Bank has guaranteed settlement in the case of multiple failures. The key point is that the LVTS is able to provide the highly desirable properties of well-designed large-value payments systems (including both net and gross settlement systems), namely, certainty of settlement and intraday finality.

Ref #	Hits	Search Query	DBs	Default Operator	Plurals	Time Stamp
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L4	49	"international payment" Kwic, Abs	US-PGPUB; USPAT; USOCR; EPO; JPO; DERWENT; IBM_TDB	OR	ON	2005/03/02 11:48
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L12	201	currency near2 transfer and "705"/$. ccls. Date + Kwic Abstract	US-PGPUB; USPAT; USOCR; EPO; JPO; DERWENT; IBM_TDB	OR	ON	2005/03/02 12:08